

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

California Independent System)	Docket Nos.	ER02-1656-003
Operator Corp.)		ER02-1656-004
)		ER02-1656-015
)		EL01-68-028

**REQUEST FOR CLARIFICATION OR, ALTERNATIVELY, REHEARING OF THE
CALIFORNIA ENERGY RESOURCES SCHEDULING DIVISION
OF THE CALIFORNIA DEPARTMENT OF WATER RESOURCES**

Pursuant to Rule 212 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“FERC,” “Commission”), 18 C.F.R. § 385.212, the California Energy Resources Scheduling Division of the California Department of Water Resources (“CERS”) hereby submits this Request for Clarification or, Alternatively, Rehearing¹ of certain findings and conclusions in the Commission’s October 28, 2003 “Further Order on California Comprehensive Market Redesign Proposal,” 105 FERC ¶61,140 (2003) (“October 28 Order”).

As more fully explained below, CERS submits that certain statements in the October 28 Order should be clarified in order to preserve an incentive for sellers to work with the California Independent System Operator Corporation (“CAISO”) and CERS to protect California consumers and help ensure market stability.² Otherwise, the market design changes proposed by the CAISO in its Amendment to Comprehensive Market Design Proposal (“Amended MD02

¹ In requesting clarification rather than rehearing, CERS relies on the legal effectiveness of the Commission’s assurances that the October 28 Order is not subject to rehearing (October 28 Order at P 2, Ordering Paragraph (C)). To the extent that the Commission conclusions in the October 28 Order are final, this filing should be considered a request for rehearing pursuant to section 313(a) of the Federal Power Act, 16 U.S.C. § 825/(b), and Rule 713, 18 C.F.R. § 385.713.

² The California Public Utility Commission (“CPUC”) shares CERS’ concern for preserving an environment in which the long-term contracts affected by the Amended MD02 Proposal may be resolved. *See* Letter of President Michael Peevey, CPUC to Chairman Patrick Wood, FERC (Nov. 3, 2003).

Proposal”) could result in significant cost increases for consumers. In the event the Commission denies the requests for clarification, CERS seeks rehearing.

I. BACKGROUND

The Amended MD02 Proposal includes a primarily conceptual design of an Integrated Forward Market (“IFM”) with a settlement regime based on Locational Marginal Pricing (“LMP”). In Comments filed with the Commission on August 27, 2003, CERS explained that the proposed LMP regime will radically alter the existing short-term power market from the current zonal-based pricing regime, under which CERS entered into long-term power purchase contracts (“State Contracts”), to a nodal-based system. Because the nodal system will place the retail customers of the investor-owned utilities (“IOUs”) at risk for congestion and counterflow costs that *cannot be hedged*, CERS urged the Commission to conclude that the proposed market redesign should not be implemented prior to a satisfactory resolution of the potentially severe impacts on the affected State Contracts, and other, non-state, long term power purchase agreements (“PPAs”).³ The State Contracts and PPAs of principal concern include contracts that arguably permit the seller to deliver its energy obligation at any bus within one or more of the CAISO’s current congestion management zones or successor zones, referred to collectively or individually hereinafter as “zonal contracts.”

CERS agreed with the CAISO that issues related to the zonal contracts must be resolved “prior to implementing LMP.”⁴ In its Reply Comments,⁵ CERS supported the comments of Pacific Gas & Electric Company (“PG&E”) and other stakeholders regarding the need to protect

³ CERS Comments, p. 3.

⁴ *Id.* at 4, 14 (quoting CAISO Transmittal Letter, p. 20).

⁵ CERS’ Reply Comments were timely filed on September 26, 2003, within 30 days of initial comments pursuant to Rule 213(d)(2)(ii) of the Commission’s Rules of Practice and Procedure, 18 C.F.R. § 385.213(d)(2)(ii), which provides that an answer to a pleading may be filed not later than 30 days after the filing of the pleading “unless otherwise ordered.” The Commission did not “otherwise order,” and the October 28 Order therefore errs in stating that CERS’ Reply Comments were filed out-of-time. *See* October 28 Order at P 18.

consumers from cost increases resulting from the market redesign.⁶ Finally, CERS explained that while it is primarily concerned with preserving the value and system-wide benefits of the CERS zonal contracts, the market redesign must protect the bargained-for benefits of *all* existing contracts for *all* parties, and in particular the zonal contracts.⁷

In the October 28 Order, the Commission approved “in principle many of the conceptual market design elements submitted by the CAISO,” provided guidance, sought additional information and established a technical conference to address certain issues raised by the Amended MD02 Proposal.⁸ In particular, the Commission “[a]cept[ed] the CAISO’s proposal to implement LMP and the Integrated Forward Market in redesigning its congestion management system.”⁹ But the Commission’s acceptance was expressly conditioned upon the achievement of mutually acceptable solutions to significant problems associated with CAISO’s proposals on bidding and scheduling concepts, the Residual Unit Commitment (“RUC”) process, congestion revenue rights (“CRRs”), and existing transmission contracts (“ETCs”).¹⁰ The October 28 Order, however, did not expressly condition acceptance of the CAISO’s proposal on a satisfactory resolution of the State Contracts or the broader category of zonal contracts.

The Commission designated the October 28 Order as non-final for purposes of rehearing, stating:

As this order provides guidance only and the matters discussed are subject to further proceedings and orders, this order is advisory in nature and not subject to rehearing. However, parties may revisit these issues de novo after the CAISO files a comprehensive tariff.¹¹

⁶ CERS Reply Comments, p. 1-2. PG&E expressed the need for “the CAISO to resolve the issues in a satisfactory way before proceeding with the implementation of a new market design that could have negative impacts on CERS contracts.” Comments of Pacific Gas & Electric Company, p. 9.

⁷ CERS Reply Comments, p. 5-6.

⁸ October 28 Order at P 2.

⁹ October 28 Order at P 3.

¹⁰ Id.

¹¹ Id. at P 2; *see also*, Ordering Paragraph (C).

II. SPECIFICATION OF ISSUES REQUIRING CLARIFICATION OR, ALTERNATIVELY, REHEARING

In keeping with the Commission's directive that the October 28 Order is *advisory only*, CERS seeks clarification that:

1. **CAISO may not implement LMP unless and until a means of protecting the State Contracts, and other similarly-situated zonal contracts, from exposure to potentially significant increases in congestion and counterflow charges has been identified and implemented; and**
2. **the October 28 Order's suggestion that CERS knew such market changes were possible, even probable, is *not* a final determination, and is not based on an adequate examination and understanding of the circumstances in which the State Contracts were negotiated and executed.**

To the extent the Commission denies these requests for clarification, CERS seeks rehearing.

III. REQUEST FOR CLARIFICATION OR, ALTERNATIVELY, REHEARING

- A. **The CAISO Should Be Clearly Directed To Reach an Acceptable Resolution of the Existing Bilateral Contracts Issue *Prior to Implementing LMP*.**

In the October 28 Order, the Commission "direct[s] the CAISO to proceed with drafting its white paper, soliciting and addressing comments, and proceeding with a stakeholder forum to address options for resolution" of bilateral contract issues.¹² While CERS appreciates the encouragement, such a resolution will be meaningless if it is only achieved after implementation of LMP. In order to avoid the seriously damaging consequences of initiating LMP without an accommodation for all existing zonal contracts, the Commission must clarify that the CAISO may not implement LMP prior to finding a solution for this problem. Otherwise, the Commission will reduce or eliminate incentives that counterparties may have to resolve these concerns.

¹² October 28 Order at P 60.

Despite the Commission’s direction to the CAISO to continue working on the problem,¹³ the October 28 Order’s characterization of the bilateral contract issue as a “*perceived variation* in the manner in which such contracts operate” fails to reflect the magnitude of the problem and the urgent need for resolution.¹⁴ The implementation of LMP in the absence of a solution will result in very real and very large cost impacts on retail customers.

Moreover, CERS’ role in executing the State Contracts was unique. The Commission’s October 28 Order fails to recognize that uniqueness and reaches conclusions that are neither valid nor applicable. The October 28 Order states that “[t]he initiation of LMP in PJM and ISO-NE caused similar commercial issues between *buyers and sellers* of ‘seller’s choice’ contracts,”¹⁵ and that “where existing contracts provide an opportunity for the parties to them to negotiate towards a mutually acceptable settlement of the manner in which *future dealings* between them will occur in light of changes in market design, we encourage such negotiations to proceed.”¹⁶

No buyer in either PJM or the ISO-NE is similarly situated to CERS. In addition, there are significant differences between CAISO’s market and grid and those in PJM and ISO-NE.¹⁷ CERS was not a traditional “buyer” at the time the State Contracts were entered into, and it is unlikely there will be “future dealings” between the contract parties as contemplated in the October 28 Order. As CERS previously explained, the State Contracts were entered into at the direction of the California Legislature to stabilize the markets at the height of the California Energy Crisis.¹⁸ But, under state law, CERS’ authority to procure wholesale power expired on

¹³ October 28 Order at P 50.

¹⁴ October 28 Order at P 58 (emphasis added).

¹⁵ October 28 Order at P 58 (emphasis added).

¹⁶ October 28 Order at P 59 (emphasis added).

¹⁷ See CERS Comments at p. 22.

¹⁸ See CERS Comments at p. 5-6.

January 1, 2003. *See* Cal. Water Code Section 80260. And through proceedings at the California Public Utilities Commission, the State Contracts have been allocated to the individual IOUs, although CERS remains legally and financially responsible for their administration. Therefore, CERS will not be a buyer in any future contracts with the sellers, and the sellers therefore have no incentive of “future dealings” to renegotiate the existing contracts with CERS.

Every major stakeholder that commented on this issue has expressed serious concerns about the impacts on bilateral contracts. As the Order itself acknowledges, “[t]he CAISO . . . Governing Board recognizes the legitimacy of this transitional issue.”¹⁹ The CAISO not only acknowledged CERS’ concerns, it stressed the importance of resolving the CERS zonal contracts and other bilateral contract issues “*prior to implementing LMP.*”²⁰ Similarly, Pacific Gas & Electric Co., whose customers will bear a share of the cost increases absent a solution, confirmed that the State Contracts, as a whole, are “one of the major elements that has stabilized the market and limited the ability for real time gaming and exercise of market power,” and stressed the need to resolve these issues “in a satisfactory way *before proceeding with the implementation* of a new market design”²¹ In keeping with these assessments, the Commission should clarify that CAISO must achieve a mutually acceptable resolution to the incompatibility of the proposed nodal settlement regime with zonal contracts prior to implementing LMP.

The Commission took “note” of CERS’ concerns that LMP will lead to huge cost increases for consumers, but then set aside those concerns on the basis that the revised market design will not “alter contractual rights.”²² CERS respectfully submits that determining whether

¹⁹ October 28 Order at P 55.

²⁰ Transmittal Letter, p. 20 (emphasis added).

²¹ Comments of Pacific Gas & Electric, p. 9 (emphasis added). Similarly, NCPA, while opposing an exception tailored only to the State Contracts, acknowledges that contracts with floating delivery points “may allow for gaming or windfall profits solely due to the proposed change in market structure.” Protest and Comments of the Northern California Power Agency, p. 8.

²² October 28 Order at P 59.

the new market design will “alter contractual rights” is not the relevant inquiry. The concern raised by CERS, PG&E, NCPA, and others is that implementation will eliminate the bargained-for benefits of bilateral contracts, to the detriment of consumers -- the constituency FERC is charged with protecting under the Federal Power Act -- by radically overhauling the regulatory environment in which those contracts were negotiated and executed. As CERS explained previously, substantial precedent stands for the proposition that where changes in regulatory policies render existing contracts uneconomic, FERC has an *obligation* to mitigate those impacts.²³

The urgency for Commission direction on this issue is heightened as the impacts of the specific design details become known and are subjected to analysis. CERS has prepared a draft study showing the potential for increased costs from the market redesign. The study, which will be released shortly for public comment, indicates that the magnitude of the impact is far greater than previously anticipated, and is not confined to the CERS zonal contracts. CERS is encouraged by the Commission’s renewed interest in reaching an equitable solution to the zonal contract issue, as expressed in the comments of Chairman Wood at the November 6, 2003 Technical Conference.²⁴

CERS further submits that the Commission’s treatment of the zonal contracts falls short of the care accorded other existing contracts which may be adversely affected by other elements of the Amended MD02 Proposal, namely the ETCs. CERS requests that the Commission clarify its intent to apply the principles and policies requiring preservation of the benefits of existing contracts consistently to all existing contracts, *i.e.*, existing zonal power purchase contracts as

²³ See CERS Comments, p. 17 (discussing Associated Gas Distributors v. FERC, 824 F.2d 981, 1027 (D.C. Cir. 1987); *see also*, October 28 Order at PP 201, 202.

²⁴ See California Technical Conference on Wholesale Power Market Design, Nov. 6, 2003, Tr. 142:1-7, 145-46:25-4, 19-21.

well as ETCs. Still, a disparity exists in the October 28 Order. With respect to ETCs, the Commission explained that

the extent to which it is possible that scheduling changes submitted by ETC holders cannot be accommodated is not presently known. Market participants, customers and the Commission are therefore relying on a description of how the proposal will work in theory, without the benefit of more detailed evidence of the magnitude of the problem sought to be addressed, and the likely consequences of implementation of the proposal, including any potential variations in costs.²⁵

Therefore, the Commission made clear that “[w]e will be in a position to provide a definitive ruling on the ETC proposal *only when further details have been settled and submitted for our consideration.*”²⁶ Similarly, the Commission expressly conditioned its approval of LMP on a satisfactory resolution of concerns associated with the RUC process, CRRs, and bidding and scheduling concepts. The same set of considerations applies equally to the impact of LMP on zonal contracts, in particular the CERS zonal Contracts, which were entered into at the height of the Energy Crisis at the express direction of this Commission. Accordingly, the Commission should clarify that, as with ETCs and other design elements, it will provide a “definitive ruling” on the CAISO’s LMP proposal only when further details regarding resolution of the existing zonal contracts have been settled and submitted for our consideration.

Given the absence of market forces that might traditionally bring parties to the negotiating table in a spirit of cooperation, Commission action is necessary to guide the parties to a solution. CERS submits that with appropriate guidance from the Commission, the parties, led by the CAISO, may reach a resolution so that no party (buyer or seller) is either better or worse off under existing contracts, and in particular zonal contracts, as a result of the implementation of LMP. Thus, in light of the unique circumstances surrounding the CERS zonal contracts, the

²⁵ October 28 Order at P 201 (emphasis added).

²⁶ October 28 Order at P 202 (emphasis added).

Commission should direct the CAISO to achieve an immediate resolution of this issue prior to the implementation of LMP.

B. The Commission Should Clarify its Statement that CERS Knew “Such” Changes in Market Design Were Possible, Even Probable.

The October 28 Order states that CERS “knew such changes in market design were possible, perhaps even probable...”, and that CERS has the ability to negotiate a mutually agreeable resolution.²⁷ Yet, both the Commission and the CAISO have acknowledged that the Amended MD02 Proposal lacks specificity, is primarily conceptual, and will require further vetting among stakeholders, at the very least. Because of the developmental nature of the proposal, the Commission expressly conditioned its acceptance of the revised market design on further study, assessment, negotiation, and appropriate modification of several key elements. Given the fact that -- even now, after months of proceedings and several rounds of comments -- many important details of the revised market design remain to be determined, it is not reasonable to assume that CERS could have anticipated the market design changes that are currently on the table. Rather, the extent of the financial impacts of those market design changes is only now becoming evident as a result of the CAISO’s Amended MD02 Proposal. Furthermore, there is no evidence as to the extent to which CERS knew the market design changes would impact the financial structure of the contracts – the Standard Market Design Notice of Proposed Rulemaking was not issued until July 31, 2002, *after* the State Contracts were negotiated and executed.

Therefore, CERS requests that the Commission clarify that, consistent with its designation of the October 28 Order as a non-final order, the suggestion that CERS knew “such”

²⁷ October 28 Order at P 58. As described above, the idea that simple commercial renegotiation of the Zonal Contracts is likely does not reflect the reality of those Contracts’ origin.

market design changes were imminent is indeed non-final. Such clarification is necessary in order to avoid the prejudicial effect that such a finding would have on CERS' ability to reach a resolution of this contract issue and to protect the interests of California ratepayers.

III. CONCLUSION

The Commission's October 28 Order essentially gives a conditional green light to LMP. While expressing a desire to resolve the issue, it does not clearly direct the CAISO to satisfactorily address the significant economic impact of LMP on the retail customers of the investor-owned utilities prior to implementation in the California markets. As the CAISO, PG&E, NCPA, other stakeholders and managers of LMP-based systems have all acknowledged, the incompatibility of the State Contracts and other zonal contracts with LMP-based settlements is much more than a "perceived variation". The magnitude of the congestion and counterflow charges that buyers under zonal contracts will be exposed to calls for the Commission's acknowledgement and action. In short, the Commission must tell the CAISO that implementation of LMP must be contingent upon resolution of the zonal contracts issue.

In requesting clarification, CERS seeks nothing more than the treatment accorded existing transmission contracts in the October 28 Order. As CERS stated in its Reply Comments, it is not seeking "special treatment" for the State Contracts or the zonal contracts generally, but rather a solution that preserves the benefits of *all* existing bilateral contracts.²⁸ In order to provide the necessary incentive to resolve this issue, the Commission must step in. The market alone will not provide such an incentive. Such action would signify the Commission's recognition of the existing lack of incentive to negotiate which results from the uniqueness of the State Contracts as well as CERS' position as a non-traditional buyer and essentially a one-time market participant. Accordingly, the Commission should clarify that it will issue a "definitive

²⁸ See CERS Reply Comments, p. 5-6.

ruling” on the LMP proposal *only* when a mutually acceptable resolution of the zonal contracts issue is reached.

In the event the Commission does not grant the requested clarification, CERS alternatively requests that the Commission grant rehearing and, upon rehearing, find that:

1. substantial evidence does not exist to support a conclusion that CERS knew or should have known the details or financial impact of the CAISO’s Amended MD02 Proposal on the State Contracts;

2. implementation of the CAISO’s Amended MD02 Proposal may not proceed until a satisfactory resolution of the treatment of zonal contracts in particular has been reached;

3. CAISO shall conduct further analysis of its proposal to demonstrate that it will not interfere with existing contractual rights and that the treatment of the existing State Contracts, and in particular the CERS zonal contracts, is not unduly discriminatory, and shall present the results of the analysis to stakeholders and interested parties for further consideration and discussion; and

4. a definitive ruling on the CAISO’s Amended MD02 Proposal will be provided only when further details regarding resolution of the zonal contracts issue have been settled and submitted for Commission consideration.

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Respectfully submitted this 26th day of November 2003.

By: /s/ Paul Stein

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Certificate of Service

I hereby certify that I have served the foregoing document by first class mail or fax upon each party identified on the official service list compiled by the Secretary for these proceedings.

Dated at San Francisco, CA this 26th day of November 2003.

/s/ Paul Stein _____

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